POSTWAR IRAQ'S FINANCIAL SYSTEM: BUILDING FROM SCRATCH

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> If I am permitted to dream, Iraq will develop into the Japan of the Middle East.[1]
> – Talib al-Tabatie, chairman, Iraq Stock Exchange

> The best thing is to overhaul the whole financial system. It's like when you have a house infested with termites. It's much easier to knock it down and rebuild than to keep spraying for termites and fixing the holes.[2]
> – Rubar S. Sandi, head, U.S.-Iraq Business Council

In the midst of daily reports of suicide bombings, insurgents, coalition casualties and the relentless toll of civilian dead and wounded, any appraisal of Iraq's economy has seemed irrelevant when set against the greater military and security concerns. Yet the long-run health of the economy will be crucial in determining whether Iraq will be able to make the transition to a stable democracy.

Many authorities on post-conflict reconstruction feel that the interim government's most significant challenge will be delivering measurable improvements to the Iraqi people. The importance of this goal was summed up by Amatzia Baram, senior fellow at the U.S. Institute of Peace: "I think the new government will gain legitimacy in the eyes of the people on one condition: if it delivers on security, infrastructure and employment. . . . If [Iraq's leaders] manage to deliver, even on the latter two, it will make a major difference. If not, the whole thing will fall apart."

Significantly, a large proportion of interim Prime Minister Iyad Allawi's initia address focused on the economic issues confronting Iraq. Allawi, a Baathist who served in the Iraqi intelligence services until falling out with the regime and leavi Iraq in 1971, cited inflation, unemployme and weak purchasing power as the main economic problems. He indicated that th government planned to stabilize the dina exchange rate, improve living conditions and boost oil output. While he offered n specific plan for addressing these issues, he did at least acknowledge that, a year after the fall of Baghdad, the country's economy is at a watershed.

If the security situation does not improve considerably, efforts to rebuild t economy will be fruitless. Yet improvements in the economy are critical for dampening the insurgency. In testifying before the Senate Foreign Relations Committee, senior Iraqis have stressed repeatedly that a key reason Iraqis have not cooperated with the coalition against the insurgency has been resentment over the lack of progress in improving conditions and solving unemployment.

The interim government's economic strategy to date is a continuation of the basic approach[3] laid down by the Coalition Provisional Authority (CPA). Briefly, the plan encompasses the creation of (a) openness and transparency of Iraq's institutions, (b) strong incentives for private-sector development, (c) close economic and financial integration with the international community, (d) international standards and best practices, and (e) a social safety net that addresses the needs of all Iraqis.[4]

While many factors within this framework will play a key role in the economy's recovery, emphasis on free markets and private-sector investment suggest that the creation of a viable, efficient financial system will be the key to the country's economic recovery. In this regard, a recent UN needs assessment notes:

> With a dysfunctional financial system featuring a poorly organized regulatory framework and ineffective institutions, the task of rebuilding a sound and safe modern financial sector in Iraq is daunting. It should start with the banking sector which is currently the essential component of the financial system and should cover the sector's legal and regulatory aspects as well as its main institutions. This would be a long-term process that will require significant resources, technical as well as financial.[5]

To gauge the progress made to date in laying the foundation for the country's economic recovery, the sections below examine the main developments in the Iraqi financial system since the fall of Saddam Hussein. In particular: (a) What was the condition of the banking system before March 2003? (b) What are the key institutional structures that have been put in plac over the last year? (c) Are these institutional structures consistent with the country's basic economic structure and position in the world economy? (d) What are the key indicators to watch in assessin progress made at various points in the future?

ECONOMIC LEGACY OF THE CPA

In the fall of 2003, with Iraq's economy still shattered and little recoverec following the ouster of Hussein, the CPA initiated a package of free-market reforms reminiscent of the "shock therapy" programs[6] carried out in the early to mid-1990s in many of the transition economies of Central and Eastern Europe.[7] Overnight Iraq became the most open economy in th Arab world.[8]

While there had been persistent rumor that major free-market reforms were contemplated, most observers were surprised at the extent to which they embodied key elements of the neoliberal agenda. As *The Economist* noted[9]: "If carried through, the measures will represent the kind of wish list that foreign investors and donor agencies dream of for developing markets." The main thrust of the neoliberal reforms centered around fiv key provisions:[10]

1. Investors (except for all-important oil production and refining) would be allowed 100-percent ownership of Iraqi assets, full repatriation of profits and equal legal standing with local firms.
2. Foreign banks would be welcome to

establish operations immediately or to purchase equity shares in existing Iraqi financial institutions.

3. Income and corporate taxes would be capped at 15 percent.

4. Tariffs would be reduced to a universal 5-percent rate, with none imposed on food, drugs, books or other humanitarian imports.

5. Although no precise timetable was set, Iraq's state-owned enterprises (SOEs), excepting the oil sector, were to be privatized (although the method of privatization was not specified).

The tax treatment, in particular, is a classic application of supply-side economics similar to the programs introduced in the United States in the early 1980s.[11] As explained by Iraqi Finance Minister Kamel al-Gailani, low tax rates will help create strong incentives for future investment and employment and limit the size of the public sector, simplify in order to minimize the administrative costs of tax collection, create transparency to minimize tax evasion and corruption, and promote fairness to ensure that all sectors pay reasonable shares of future taxes.[12]

The CPA reforms were also complemented by a series of measures designed to strengthen institutions critical for the establishment of a free-market economy. Most important in this regard were initiatives designed to establish a viable banking sector. The CPA's Order Number 40, issued on September 19, 2003 (and updated in a slightly modified form[13] under Order No. 94, issued in June 2004), defines the rules establishing and governing the new Iraqi banking system and, in so doing, provides a foundation for Iraq's future economic growth and development.

THE BANKING SYSTEM

The banking sector in Iraq dates back to the mid-1930s, when branches of foreign banks and private Iraqi banks were opened. These grew as the economy expanded. However, in 1964, Iraq consolidated and nationalized private banks into what is now the Rafidain Bank, the country's largest state-owned bank. In the 1980s, the Rafidain Bank and, later, a second state bank, the Rashid Bank, were profitable largely through financing the government's budget deficits. This prosperity ended when U.N. economic sanctions were imposed in 1990. From then until the ouster of Saddam's regime, most of the state bank's business was directed toward simply underwriting the Iraqi military and then the ruling party. The government opened its banking sector to local private banks in the early 1990s to spur business and help offset the impact of sanctions.[14]

By March 2003, the sanctions, two wars and several decades of Baathist rule had left the Iraqi banking sector in complete decay. Greatly compounding the situation was the devastation inflicted on the system during the immediate post-war period. At that time, the Ministry of Finance, the Central Bank, the Baghdad Stock Exchange and the two key state banks, Rafidain and Rashid, were systematically looted, as were a number of the 2[illegible] smaller state-owned and private banks. The situation was so serious that, even a year later, there was no proper banking sector to speak of. Iraq was still almost entirely a cash economy.

In reconstructing the banking system, the CPA was confronted with a structure unlike that in many neighboring countries. In contrast to most banks in the Gulf Cooperation Council (GCC) states, recovering Iraqi banks could not count on liquidity-driven profits. Very little liquidity existed. In addition, Iraqi interest rates were set high (17 percent) by the Central Bank. Credit demand was great, and money-lending (as opposed to other diversified non-interest revenue) was the principal source of bank income. Also, in contrast to neighboring countries, there was little demand for Islamic banking. Other than one small private bank, the Iraqi Islamic Bank for Development and Investment, Islamic banking was for all practical purposes non-existent.

In March 2003, the banking system had the equivalent of some $2 billion in assets, of which over 85-90 percent was in the two state banks. These assets represented only around 8 percent of Iraq's GDP, an extremely low ratio by international standards, underscoring the marginal role played by the banking sector both as a provider of resources to the economy and as a store for national savings.[15]

In an effort to establish a viable banking sector, the CPA issued Order Number 40 on September 19, 2003 (and modified slightly under Order 93 in June 2004). The provisions of the Banking Law were modeled significantly after the Western approach to bank regulation. They grant the Central Bank of Iraq (CBI) full legal and operational authority. Most important, the Banking Law provides Iraqi banks with the powers and authorities associated with those of modern banks operating in today's international financial system. However, despite the fact that Islamic banking practices are potentially just as efficient as those of traditional banks,[16] the Banking Law is silent on their status.

THE CENTRAL BANK OF IRAQ

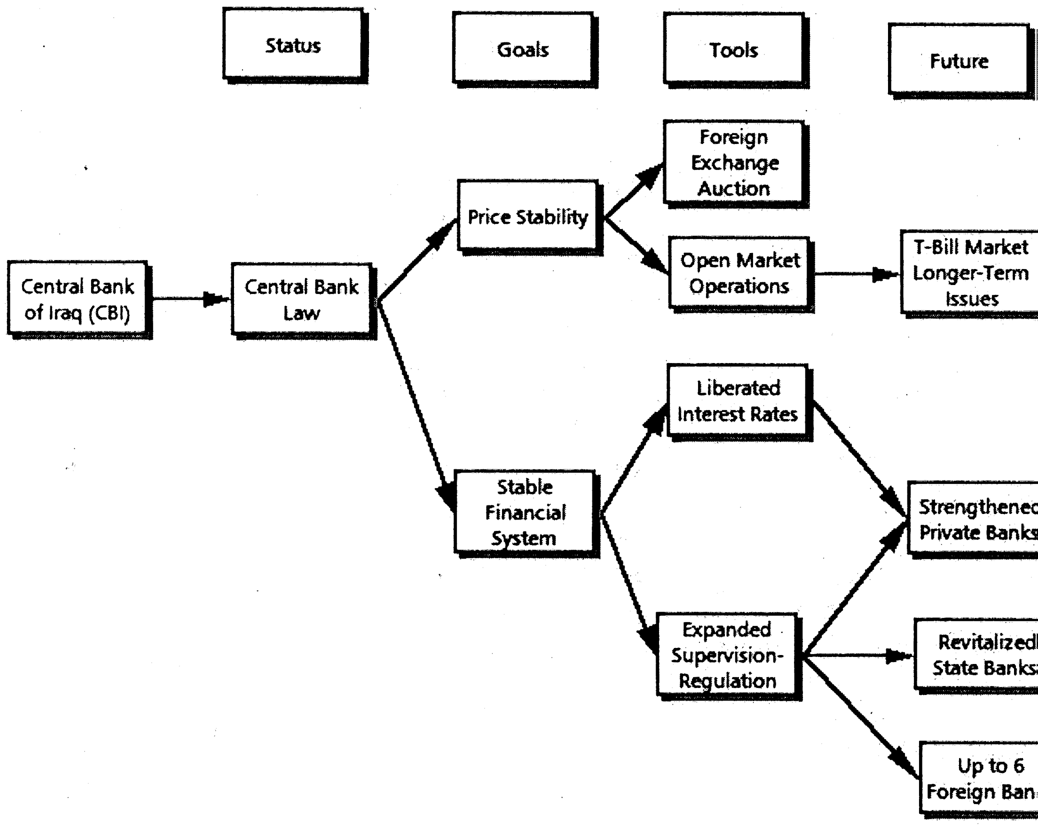
As a necessary step in developing a dynamic commercial banking system, much of the CPA's initial focus was on strengthening the Central Bank of Iraq (CBI). Here, the most significant development has been the issuance of the Law to Govern the Central Bank of Iraq, which went into effect March 7, 2004.[17]

In contrast to the past, the CBI was made independent of government coercion and control. Procedures were put in place to assure higher levels of transparency and accountability. Most significant, the CBI will no longer be required to lend to the various Iraqi ministries and has the authority to undertake monetary policy independent of the Finance Ministry. In sum, the Law to Govern the Central Bank of Iraq envisages a modern central bank that will bring greater price stability, foster a market-based financial system and promote sustainable growth, employment and prosperity (Figure 1). In addition, the new law empowers the CBI to to the following:

1. Take charge of the country's monetary policy, including exchange-rate policy.
2. Act as a fiscal agent of the government, performing financial operations including the issuing and redeeming of the Ministry of Finance's securities.
3. Grant government-owned commercial banks loans on the same terms as privately owned commercial banks.
4. License and supervise both state-owned and private commercial banks, including foreign banks.

Consistent with the new economic philosophy of the CPA, interest rates have been liberalized (effective March 1, 2004), allowing their values to be determined by market forces.[18] As part of the September

Figure 1: Central Bank of Iraq



2003 investment law, the CBI also plans to establish insurance to provide additional protection to small and medium-sized depositors.

Monetary Policy

Perhaps the biggest challenge to confront the CBI is its ability to effectively conduct monetary policy. To do this, the CBI must be able to regulate either the interest rate or the quantity of money and credit in the economy. Normally, monetary policy operates through affecting the underlying demand and supply conditions in foreign exchange, money or interbank markets. In early 2004, these markets were either non-existent or extremely underdeveloped[19]:

1. There was no primary market in Iraq for government debt. Uncertainty surrounded the small secondary market in debt issued by the Hussein government. That debt may become worthless should new government decide not to service it.

2. No functioning markets for debt or equity securities offered by the private Iraqi firms existed, although the Baghdad Stock Exchange was expected to open once new reporting and accounting standards were in place.

3. The country had no interbank market, linking banks via a payment and settlement system. The absence of this market made it nearly impossible for the CBI to set an effective reference interest rate or adjust the monetary base.

4. The quantity of base money could be affected only by altering the amount of currency in circulation, a very inefficient process, given uncertainties over the amount of outstanding currency and the demand.

As Stève Hanke, economics professor at The Johns Hopkins University, correctly notes,[20] until these key markets are developed, CBI will be forced to utilize direct instruments that work through involuntary regulations. He sees as likely candidates controls on banks' deposit and lending rates, as well as the use of credit floors and ceilings. Unfortunately, such involuntary restrictions are likely to impose two costs. First, they will make it impossible for banks to allocate their portfolios in response to market signals. Second, the restrictions will dampen competition for deposits. The net effect will most likely retard the country's much-needed financial development.

Some progress has been made in developing several of the markets critical to the financial sector's success. On June 4, 2004, U.S. administrator Paul Bremer signed the public-debt law. This new statute stipulates that the Iraqi government will be required to honor all of its previous domestic debts to Iraq's commercial banks, debts largely contracted by Saddam Hussein. This "Saddam Paper" is estimated to be around 1.3 trillion dinars. The public-debt law can therefore be seen as a way to bring funds back into Iraq's banking sector, much of which would otherwise face bankruptcy due to insolvency.

The Iraqi Central Bank also holds about $2.5 billion in Iraqi government debt. Under the Bond Market Plan put together by the CPA, that debt must be paid as it matures. However, because the CPI was made independent, the government cannot force the bank to buy its paper, as was done under Saddam.

Given these domestic debt-servicing obligations, as well as a cash shortage, the interim government is attempting to develop a domestic bond market as an additional source of finance. Iraq's finance minister, Adel Abdul-Mahdi, noted, "It's a way to recover the economy. We are issuing new treasury bills not only to finance the repayment of treasury bills outstanding from the former regime, but to regulate the market and determine interest rates." On July 18, 2004, the Central Bank of Iraq raised about 150 billion dinars ($103 million) for the government, selling three-month bonds.

The bonds offered a market-determined interest rate of 5-8 percent, not enough to entice foreign banks given the political risks involved. Instead, the vast majority of the buyers were local banks, and the auction was a first step in laying the groundwork for further borrowing. Three-month bonds were chosen for their short maturity, allowing the government to prove that it is credit-worthy. It plans to issue six-month and one-year bonds later in 2004 in an effort to raise as much as $1.2 billion by the end of the year. It is expected that the development of a government debt market will introduce another constraint on the government. If it overspends, as Saddam did, investors will demand higher interest rates.

In a related initiative, the interim government began implementing a CPA-initiated program, the revamping of the old Baghdad Stock Exchange. The new Iraq Stock Exchange opened on June 24, 2004, the product of more than a year's work on a regulatory framework undertaken by the 12 brokerage firms and banks that jointly own it. The Iraq Stock Exchange has 27 companies with about 100 to go public before the fall, and a total of 180 to 200 expected by the end of the year.[21] In the first five sessions, trading volume nearly quadrupled, and the value of some stocks surged more than 600 percent.[22] Since then, the exchange index has been somewhat eratic, with many of the country's commercial banks selling shares for one dinar each, "offering this bargain as a lure for investors who are counting on the banks to stop issuing new shares as a prelude to raising share prices."[23]

The old stock exchange comprised only Iraqi companies and traders, while the new bourse will eventually be accessible to foreigners. The key to the exchange's success is a strong regulatory framework, transparency and accountability. A shift to an electronic trading system will be introduced in the near future. Hopefully the stock market will begin to lure money back from Iraqi citizens living overseas.[24] On the other hand, many investors complain that the government has restrained the market by putting off a decision on whether to permit foreigners to buy and sell shares.[25]

Exchange-Rate Policy

A foreign-exchange market has also been created with the introduction of the Iraqi dinar. As with the money markets, the Central Bank was given independence in its conduct of exchange-rate policy. While many experts recommended a fixed exchange-rate regime whose stability might be more attractive to foreign investors, the CBI has opted for a "managed" floating regime.

Before the development of an active bond market, the CBI was forced to control the money supply (and indirectly the exchange rate) through its buying and selling of dollars. This resulted in a fairly volatile dinar/dollar rate. In fact, at one point in late 2003, the currency rallied from 2,000 dinars to the dollar to 1,400 following the phasing out of the old Saddam notes.[26] However, the volatility of the exchange rate does not necessarily bode well and may indicate that speculative forces rather than market-based efficiency considerations were driving the rate. Speculation may explain the paradox of a strengthening dinar in December 2003 while prices for basic goods in Iraqi markets remained the same or rose even further.[27]

In practice, exchange rates in the street markets have provided guidance to the CBI, which provides dollars to the commercial banks in a daily auction. Under the managed floating arrangement, the CBI is free to buy dollars if it deems the dinar too dear or if the banks wish to sell dollars, or sell if there is bank demand to buy dollars or if the dinar depreciates. By mid-2004, the CBI had intervened in this manner on several occasions to curtai[l] sharp speculator-driven appreciation.

With the introduction of a minimal tari[ff] structure, the economy is facing world price levels for the first time since UN sanctions were imposed after the Gulf Wa[r,] forcing painful adjustments in employmen[t] and/or wages and prices. This shock is likely to be replicated by the recovery of [o]il production and the expenditure of donor funds. Both will produce upward pressur[e] on the currency, raising the likelihood that many non-oil sectors will be priced out of international markets – the so-called "Dutch disease."

The main advantage of the dinar's managed float is that adjustments to changes in the terms of trade (the oil price) can be made in the exchange rate, rather than in wages and prices. Yet this does not solve the Dutch disease problem. Facing a similar situation, several other natural-resource exporters have established stabilization funds. These keep some part of the oil revenues in a centrally managed fund held in foreign currency assets, thereby reducing inflows into the local currency and thus appreciation. The fund should accumulate in good times and deplete in bad times, thus providing a stable balance-of-payments environment.[28]

Direct payment of oil receipts to Iraqi citizens would also have the advantage of creating broad-based purchasing power and thus encouraging the development of small and medium-sized domestic firms (SMEs) catering to the domestic market. SMEs have traditionally been the biggest source of job creation in the transition economies of Eastern Europe.

An alternative to the flexible exchange-rate policy[29] might have been the adoption, at least initially, of a fixed exchange rate managed through a currency board. Postwar Bosnia and Montenegro both have stable currencies today, thanks to currency boards linked to the euro.[30] Iraq could have established one with the dinar linked to the dollar, the euro or an index based on both. This would have required considerable hard-currency reserves, perhaps unrealistic amounts under the circumstances.

Another factor favoring flexible rates in Iraq centers on problems likely to develop if the country pegged to the dollar or euro the currencies of net oil importers. For example, maintaining a fixed peg to the dollar would require Iraq to tie its monetary policy to that of the United States. The likely result would be interest-rate movements counter to the country's best interests. During periods of oil-price increases, the United States would likely pursue an expansionary monetary/low-interest-rate policy to maintain domestic demand. In this environment, just the opposite, a tight monetary/high-interest-rate policy, would be best for dampening inflationary pressures in an Iraq awash with dollars.

In short, there are distinct advantages to Iraq in adopting a fixed exchange rate, at least until monetary institutions and associated markets are developed and efficient. Ultimately the choice of the degree of flexibility of the exchange-rate regime depends on the objective function of the authorities as regards the trade-off between the desire to dampen exchange-rate volatility, and control inflation by using the exchange rate as a nominal anchor, and to reduce fluctuations in output by allowing the nominal exchange rate to absorb shocks.

As it stands, however, the decision to proceed with a flexible exchange rate means that monetary policy must allocate the task of domestic stabilization, with fiscal policy focused on balance-of-payments stability. In essence, the government must rely on its weakest economic tool – monetary policy – to tackle the country's massive unemployment problem. In this environment, we are likely to see fairly wide fluctuations in exchange and interest rates; hopefully these rate movements will not significantly discourage much-needed private investment and foreign-capital inflows.

Despite these concerns, the exchange rate has been relatively stable. Demand for the Iraqi dinar has been so strong that the Iraqi government earned approximately $5 billion in seignorage between October 2003 and October 2004.[31] Part of this stability amid the chaos stems from the steadfast willingness of the CBI to convert dinars into dollars. Under these circumstances, there is unlikely to be much impact on the currency from the lack of stability in the country.[32]

In sum, if the framework established by the CPA is maintained, Iraq will develop a highly open economy. Just as important, it will have many of the modern financial institutions governed by international standards needed to operate in this environment. Economic theory suggests that this system is best served by the combination of a managed floating exchange-rate regime and an oil-stabilization fund. However, as with many aspects of the CPA program, one is in place while the other is not. Property rights, a key element in most free-market reforms, is another neglected area. Perhaps the intent of the CPA was to simply defer many of the specific legalities to an elected Iraqi government.

MAIN AREAS OF CONCERN

Clearly the CBI faces a number of obstacles. Its ability to meet these challenges will go a long way in setting the tone for the country's financial-market development and, ultimately, the success of reconstruction efforts. In this regard, the above considerations suggest that, with regard to the CBI, the main issues to monitor include:

1. *Inflation rate*: Does the CBI have the tools and expertise to control the money supply? Bank deposits in foreign currencies increased by 26 percent in March 2004 compared with a year before; deposits in Iraqi dinars increased by 63 percent over the same period.

2. *Fluctuations in the exchange rate*: Will they be destabilizing or disruptive?

3. *Sudden Capital Inflows*: With its existing tools, can the CBI prevent speculative bubbles? Many of the transition economies of Eastern Europe and the former Soviet Union have experienced destabilizing surges of financial inflows and outflows.[33] As Iraq opens its economy, will it suffer the same fate?

4. *Exchange Rate Overvaluation*: If the exchange rate becomes overvalued, will the CBI be able correct the situation to modify the impact on private investment? Export-oriented industries may decline because of intense foreign competition for many producers for the local market (the Dutch disease).

5. *Regulation/Supervision*: Will the CBI quickly develop the expertise to effectively regulate and supervise a rapidly expanding and diverse banking system?

6. *Crisis Management*: Will the bank be able to quickly put into place emergency measures for meeting the challenge to the system posed by bank failures?

7. *Capital Market Development*: Will the bank be able to work with the Ministry of Finance to develop and create an efficient bond market?

While it's too early to form firm judgments about the CPA program's influence on Iraq's fiscal and monetary aspects, a safe guess is that, while constraining, it does not place any impediments on the Iraqis other than what are normally found in any sound financial system. The CPA-based rules and institutions simply represent the steps responsible governments must take to lay the foundation for sustainable growth. Or, in the words of Adel Abdul-Mahdi, Iraqi finance minister, "We inherited a corrupted and bad economy. It was a mafia economy rather than a market economy. We are trying to rebuild the new Iraq on a solid basis."[34]

The State Banks

While Iraq's two state-owned banks, Rasheed and Rafidain, control over 85 percent of banking assets (top, Figure 2), they are at best marginally capitalized and have loan portfolios with a high concentration of non-performing loans. Before March 2003, the banks clearly lacked modern comprehensive accounting standards and systems. Despite the fact that they had a large network of more than 360 branches, each branch operated largely as an independent unit with no real centralized management or integrated system for making and clearing payments.[35]

Developments prior to March 2003 left the state banks with a unique set of features. In contrast to their counterparts in other developing countries, Rafidain and Rasheed did not lend extensively to the corporate sector, either state-owned enterprises (SOEs) or private ones. Instead, state enterprises received most of their funding through government grants and hidden subsidies. The Iraqi government, in turn, would finance itself by issuing debt in the form of treasury bills subscribed by the banking sector – mostly Rafidain and Rasheed. As a result, treasury bills account for about two-thirds of Rafidain's assets and 50 percent of Rasheed's portfolio.[36]

At the same time, the SOEs had to place their deposits with Rafidain and Rasheed. In fact, these funds represent about half of Rafidain's total deposits. Ironically, given the limited amount of financing extended by banks to the SOEs, the state enterprises may, in effect, be net creditors to Rafidain and Rasheed.[37]

Several factors are severely restraining the activities of the state banks. In particular, the debt overhang and the attachment risk on assets by creditors are making it impossible for the public-sector banks to perform international banking functions.[38]

The U.S. Treasury has worked with the state banks in an attempt to enable them to provide better domestic services such as taking deposits, clearing checks and making loans to support business activity. There are some signs of success. For the quarter ending November 30, 2003, Rafidain and Rasheed extended loans totaling about $6 million, primarily to small and medium-sized enterprises.[39] This portfolio shift represents a sharp break from past practices.

Clearly, substantial and sustained restructuring of management, organization, personnel and systems is needed to make the state banks competitive, profitable and able to provide a wide array of high-quality financial services. Rafidain, for example, plans to lay off a third of its 7,300 employees and restructure its debt-burden balance sheet in preparation for privatization. The bank is saddled with over $20 billion of Iraq's debt. The former Iraqi government opened letters of credit through the bank that were never settled, with the debt becoming technically classified as the bank's liability.

Privatization will probably entail entering into a partnership with foreign banks rather than an outright sale of assets to those institutions. The uncertainty over the future status of the bank is no doubt taking a heavy toll on employee morale and limiting bank functioning in the short-run.[40]

Private Banks

As noted above, the government opened its banking sector to local private banks (middle, Figure 2) in the early 1990s. By the year 2000, these banks had a market share of around 6.6 percent. Also, at that time, private-sector banks had a loan market share of 21 percent, a very high rate in light of their position in the deposit market. The credit-deposit ratio for the private banks was around 52 percent, suggesting that, for the most part, private banks were quite profitable.[41]

Still, the overall performance of these banks must be classed as unsatisfactory by almost any standard. In addition to their small share of the deposit market, private banks used antiquated technology and could provide only very limited services to their customers. Because most Iraqis did not trust the government, they preferred to hold their deposits in banks outside the country, mainly in Jordan and Lebanon.

In short, private banks are still suffering from a wide range of problems, including the uncertain security situation in Iraq, the chance of instability of the Iraqi dinar, and the lack of adequate capital markets. The situation is made worse by the fact that local banks have limited capital bases, limited customer reach, outdated technologies and inadequately trained staff.[42]

Banking Law (September 2003-June 2004)

The CPA banking law addressed many of these problems:

1. Domestic banks are required to increase their capital to 10 billion Iraqi dinars within 18 months. This is expected to encourage consolidation and foreign investment.

2. Banks must maintain long-term capitalization consistent with international standards.

3. More rigorous qualifications are set for bank licensing and for bank managers and boards of directors.

4. Foreign banks may enter the market. The legislation allows for six foreign banks to enter the market over the next five-years. The Central Bank of Iraq, with assistance from the CPA, will develop procedures for foreign bank licensing and for establishing representative offices.

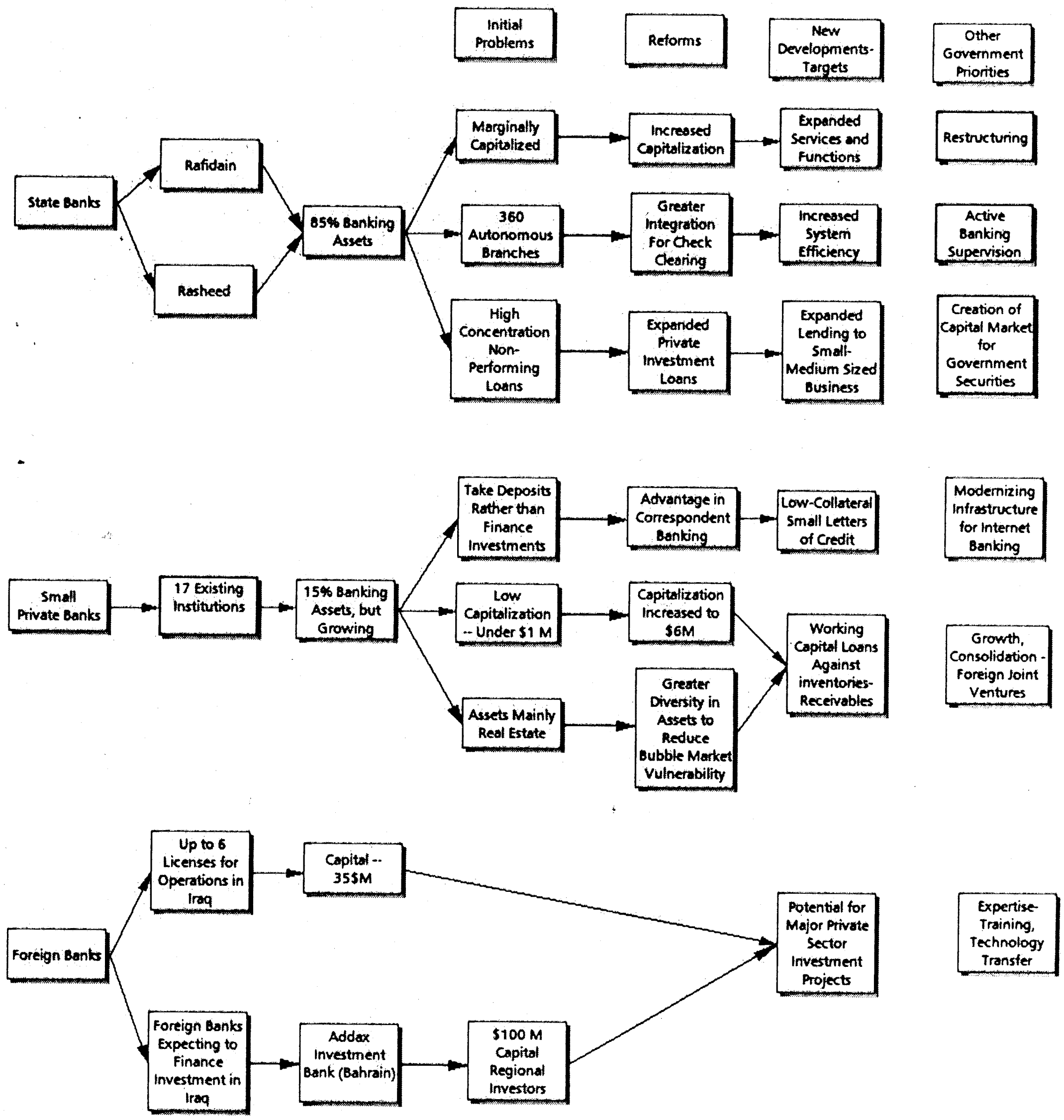
Central bank regulations and supervisory capabilities are being developed to support the new banking legislation.

Foreign Banks

While no doubt some of the existing private banks will evolve into fully functioning financial institutions, one of the most important aspects of the Banking Law is the opening up of the Iraqi market to foreign banks. These banks are expected to play an important role in increasing the availability of credit, providing a network of relationships to Iraq that will support economic growth, and accelerating the process of strengthening the banking sector through competition and the transfer of technology, know-how and best practices. Eastern European transition-economy experiences with financial-sector reforms show that one of the most important contributors to modernizing financial sectors is bringing in foreign banks.[43]

In January 2004, Britain's HSBC and Standard Chartered and the National Bank of Kuwait (NBK) were granted licenses

Figure 2: Iraq – Banking System Issues



and are expected to start up operations by the end of the year. They were selected from 15 applicants, including banks from across the Middle East. The conditions for selection focused on expertise outside a bank's home country and a commitment to invest in Iraq. The three banks have each pledged to keep a minimum of $25 million in Iraq. Standard Chartered has been expanding in the Middle East, opening branches in Jordan and Lebanon in recent years and focusing on retail. HSBC, the world's second-largest bank by market value, already operates in 12 Middle East countries. The National Bank of Kuwait is one of the largest Gulf banks. Kuwait hopes to be a base for firms eyeing Iraqi reconstruction but worried over security.

As for the future, no doubt there will be a series of mergers, with foreign banks looking at investing in the sector and financing projects (bottom, Figure 2). The recent purchase of the Iraqi Credit Bank (the first purchase of an Iraqi credit bank in four decades) by the Kuwait National Bank, if successful, may usher in a series of similar acquisitions.[44] Some of the private banks may survive by developing special niches. Many have done well in the year following April 2003. Many made good loans secured by real estate.[45] They have also been relatively successful in selling shares on the new Iraq Stock Exchange.[46]

In spite of their small size, the private banks currently have several advantages over the two large state banks. In particular, they are less encumbered in establishing correspondent relationships with foreign banks. They are not subject to having their foreign assets seized in any future Iraqi government debt-resolution scheme. The state banks will face that risk until there is a comprehensive official rescheduling and write-down of Iraq's international debts,[47] although this advantage has been somewhat lost with the November 2004 Paris Club agreement to forgive approximately 80 percent of Iraq's outstanding external debts.[48]

Part of the problem faced by Iraq's banks in the immediate post-war period stemmed from their limited services (in part brought on by the security situation). Services were limited to deposit taking, cash withdrawals and manual check clearing. The economy was essentially cash-based. Although very slow to come, one development that is very encouraging for the long-run profitability of private banks is the implementation of a new inter-bank and intra-bank payment system controlled by the CBI.[49]

This system allows for money transfer using a mechanism dubbed "original credit" (OC), which is transacted through Visa's global processing network – VisaNet. By late 2004, the VisaNet system linked 20 state and privately owned commercial banks. To sidestep problems with poor terrestrial communications networks, each of the banks' branches are able to access the network via a laptop-sized satellite communications receiver and satellite dish. The satellite communications box links to VisaNet for payment processing, acting as a host terminal for each bank.

The Trade Bank of Iraq

While some of the private banks are beginning to supply trade financing, given their limited capacity to perform this function, the Governing Council and the CPA decided to establish a bank to facilitate the imports and exports urgently needed to support Iraq's reconstruction and the transition from the U.N. Oil-for-food program. To this end, the CPA awarded a consortium led by the U.S.-based J. P. Morgan Chase & Co. the tender for operating the Trade Bank of Iraq. The consortium consists of 13 banks representing 14 countries. The Trade Bank of Iraq is planned to operate for 12 months but may continue for another two or three years, especially if the private banks and restructured state banks are still not in a position to effectively assume this business.

TEN SIGNS OF PROGRESS AND CONCERN

In judging progress in the banking area, several key developments will be of particular importance:

1. Extent to which funds are being repatri-

ated into the banking system,
2. Speed and extent of recapitalization of the private banks,
3. Progress at restructuring the state banks,
4. Extent to which foreign banks are investing in joint ventures with private banks,
5. Response of savers and borrowers to interest-rate changes,
6. Extent to which the state banks can expand loans for private-sector investment,
7. Speed and extent of diversification of bank assets away from real estate,
8. Extent to which private-bank credit fuels the consumption boom rather than private investment,
9. Extent to which banks can develop expertise to evaluate private-investment projects, and
10. Progress made in developing an efficient bond market.

Developments that may signal trouble ahead:

1. Growing reliance by borrowers on microfinance administered by NGOs,
2. Limited number (well below 15) of foreign banks applying for the next round of licenses to operate in Iraq,
3. Increased pressure on the CBI from religious groups opposed to Western-style banking,
4. Little or no investment in Iraq originating from foreign financial institutions/funds,
5. Erratic fluctuations in interest rates or the exchange rate,
6. Speculative bubbles fueled by rapid short-term capital inflows and outflows,
7. Ongoing inflation and the inability to develop a viable government bond market,
8. Ongoing bank failures, and
9. Extended reliance on the Trade Bank of Iraq.

ASSESSMENT

The relevant CPA Orders laid a solid foundation for the creation of an efficient modern banking system. While one may quibble over such things as the desirability of fixed over flexible exchange rates and the ability of the CBI to conduct precise monetary policy, it is hard to envision a more comprehensive set of institutional changes to the country's financial system. However, the CPA's efforts may be a necessary but insufficient condition for success. It is quite likely that development of the banking sector, together with its contribution to investment and economic growth, will be largely conditioned by developments in other areas: in particular, (1) the security situation, (2) progress made in resolving the country's outstanding foreign debt and (3) developments in the oil sector. The recent Paris Club reduction of 80 percent of Iraq's outstanding foreign debt has been a welcome development, largely eliminating the second concern. However, adverse developments in either of the two remaining areas could seriously impede the development of a viable, functional banking system in Iraq.

One also senses that the system laid down by the CPA, while technically correct and efficient by Western standards, was created in something of a vacuum. There does not appear to be much give and take between the CPA and Iraqi representatives in arriving at a consensus likely to be acceptable to large segments of the local population. Islamic banking, one of the most rapidly growing areas of finance in the Middle East, is not even mentioned in the voluminous documents and directives released by the CPA. As a result, there is great uncertainty over the direction the system will take once an elected Iraqi government is in power. No doubt this uncertainty, in addition to the security situation, is undermining the growth and development of this critical sector. As late as March 2004, a prominent Lebanese official noted,

> The country is full of opportunities, but the investment horizon is not clear yet. I don't think Lebanese banks will move to Iraq . . . . We don't really know what the laws are yet. [50]

In sum, what was created in Iraq is a banking system rather unique to the Middle East and one that eventually may not be accepted by the Iraqis.

> What any foreigners write or say is irrelevant unless the people of Iraq are involved. Most important, we cannot go into Iraq and build a set of institutions that reflect American and Western European values. This will not work. The new Central Bank of Iraq will belong to the Iraqis and so they have to set it up. . . . We can set out a framework of principles that appear to be universal, but the details are up to the people who live there, not us.[51]

In this sense, the Iraqi banking system may be a microcosm reflecting a larger set of issues and problems now facing the new interim government.

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